ADVANCE ECONOMIC SPOTLIGHT ON…

CHINA'S CURRENCY

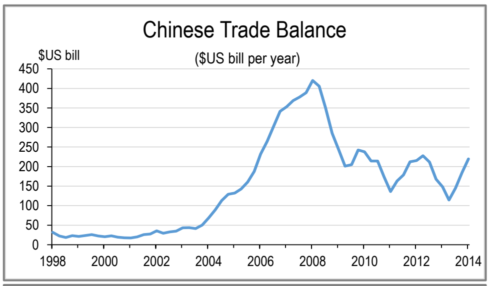
AUGUST 2015

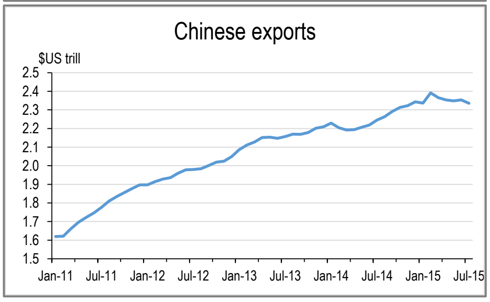
China recently moved to depreciate the yuan, dropping by 4.4% against the US dollar. Tim Rocks, Head of Market Strategy and Research, considers the broad range of implications for investors.

Background

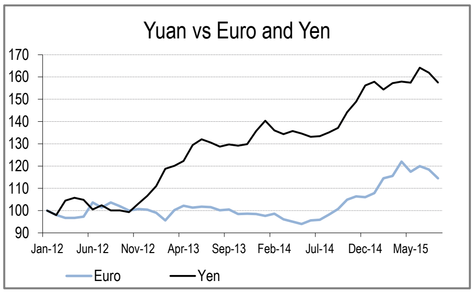
Exports played a critical role in the early stages of the China story. Helped by an artificially low exchange rate, the trade balance surged 20-fold to $US 400 billion in the decade before the financial crisis. This provided desperately needed jobs and the cash necessary to kick-start China's grand infrastructure program.

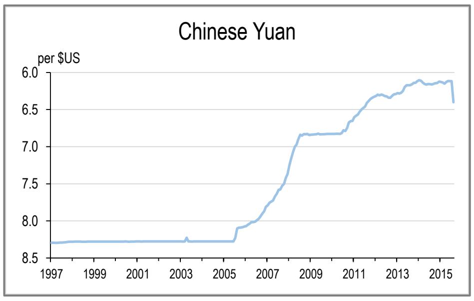
But much has changed. There has been an outright fall in Chinese exports over the past year due to the tepid global economy and as lower-cost producers including Vietnam and India have taken some of its customers.





China has also become a direct competitor of Europe and Japan as it has expanded the breadth and sophistication of its exports, particularly in technology products and industrial machinery. It has therefore been a casualty of the competitive currency devaluations that have occurred globally in the aftermath of the financial crisis. While the yuan has been relatively stable against the US dollar, since 2012 however, it has appreciated 60% against the yen and 15% against the euro as those regions have implemented their aggressive quantitative easing policies. The scale of these currency changes, and the risk it poses for the export markets that China wants to dominate, has forced Chinese authorities to act on the yuan.





Impact of depreciation

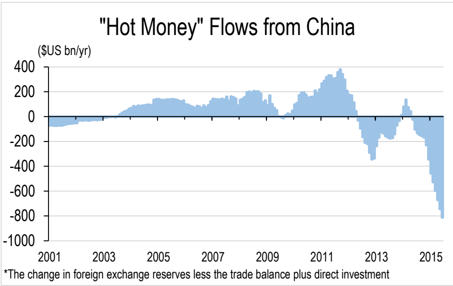
Unfortunately, it is unlikely that the yuan depreciation we have seen to date will have any meaningful impact on China's trade performance. The announced 4% move in the yuan against the US dollar is simply insignificant against the moves that have occurred against the euro and the yen.

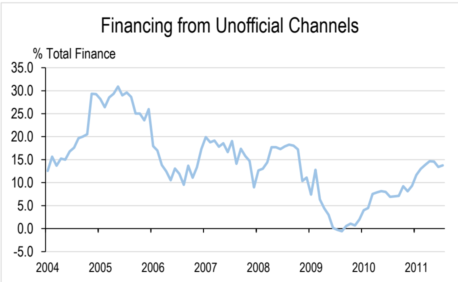
Quantitative easing is also set to continue in Europe and Japan for at least another year and will put further pressure on those currencies.

However, the announced yuan depreciation is important for another underestimated reason. It signals a major turning point in the direction of the currency; a transition from an era of steady predictable yuan appreciation to one of steady predictable yuan depreciation. This will have major implications for capital flows out of China.

During the decade of predictable yuan appreciation, capital flowed aggressively into China. Chinese exporters with excess cash were happy to invest on the mainland and reap the benefits of higher interest rates in China and a rising currency. This extra cash powered asset prices and was a key source of funding for domestic Chinese companies and local governments keen to build their bridges, roads and airports.

Such flows were estimated at around $US400 billion in 2011, and were equivalent to almost one-third of finance available in China at the peak in 2005. What now happens when there is predictable yuan depreciation, falling interest rates, and much less prospect of rising asset prices? That money flow will reverse and potentially starve the domestic financial system of funds. In fact, this exit started slowly in 2012, partly in anticipation of the currency move we have now seen.





“Hot money” outflow is on track to reach $US800 billion on this measure in 2015. Authorities will need to find alternative sources of funds to avoid financial strain. Recent moves to cut interest rates and reserve requirements are a response to this tightening domestic liquidity.

The flipside of this rising financial risk in China is that we should expect the “Hot Money” to have an impact where it lands. It points to a boost to a range of asset prices in the West from residential property in Australia, Canada, US and UK to broader debt and equity markets. In fact the start of the outflow in 2012 marries with the observed rise in Chinese investment in Sydney and Melbourne apartments around that time. And ironically the flow in US assets may end up pushing the US dollar higher against the euro and the yen, partially undermining the impact of the depreciation itself.

These outcomes represents a challenge for investors that have to balance risk and return in a portfolio and suggest more active monitoring of portfolios is essential in the period ahead.

For more information, please speak to your financial planner or call 1800 819 935.

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